United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-7203

To be argued by
RICHARD E. CARLTON

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ROBERT ABRAHAMSON and
MARJORIE ABRAHAMSON,

Plaintiffs-Appellants,

vs.

MALCOLM K. FLESCHNER, WILLIAM J. BECKER,
HAROLD B. EHRLICH, LEON POMERANCE,
FLESCHNER BECKER ASSOCIATES, and
HARRY GOODKIN & COMPANY,

Defendants-Appellees.

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT
COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR APPELLEES
MALCOLM K. FLESCHNER,
WILLIAM J. BECKER AND
FLESCHNER BECKER ASSOCIATES

SULLIVAN & CROMWELL
Attorneys for Defendants
Malcolm K. Fleschner, William J.
Becker and Fleschner Becker Associates
48 Wall Street
New York, New York 10005

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Cases	Pages
	25, 29, 30

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- x

ROBERT ABRAHAMSON and MARJORIE ABRAHAMSON, :

Plaintiffs-Appellants, : Docket No. 75-7203

-against- :

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER BECKER ASSOCIATES, and HARRY GOODKIN & COMPANY, :

Defendants-Appellees.

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BRIEF FOR APPELLEES
MALCOLM K. FLESCHNER,
WILLIAM J. BECKER AND
FLESCHNER BECKER ASSOCIATES

PRELIMINARY STATEMENT

This is an appeal by plaintiffs Robert and Marjorie Abrahamson from a final judgment entered on March 4, 1975 dismissing this action as to each of the defendants pursuant to Rule 56 of the Federal Rules of Civil Procedure on the ground that plaintiffs suffered no damages compensable under law. The opinion below of the Honorable Robert L. Carter (290a) is reported at 392 F. Supp. 740 (S.D.N.Y. 1975).

The Abrahamsons are former limited partners of defendant Fleschner Becker Associates ("FBA"), an investment partnership. They became members of the partnership in 1965.

when they withdrew from the partnership on September 30, 1970, they had earned a net profit of $289,000 on their $599,499.35 investment or almost 50 percent in five years. They nevertheless claim that, because the defendants failed to advise them of the partnership's investment in unregistered securities, they are entitled to recover from the defendants an additional $1,254,800, or, in essence, the difference between the maximum value which their investment in the partnership ever attained and the amount which they received upon withdrawal.

COUNTERSTATEMENT OF ISSUES PRESENTED FOR REVIEW

1. Whether the plaintiffs, whose participation in FBA netted them a profit of $289,000, may maintain an action to recover, from the partnership, its general partners and accountants, an additional $1,254,800 in paper "losses," where neither the partnership nor its general partners nor its accountants profited from the plaintiffs' alleged "loss"?

2. Whether a Section 10(b) claim for damages is established where limited partner plaintiffs, while neither purchasing nor selling, signed a partnership agreement containing minor revisions mostly beneficial to them at the time when their partnership shares had reached peak value, even

though plaintiffs profited from their investments and defendants did not profit from the "paper loss" which plaintiffs seek as damages?

3. Whether the federal courts have jurisdiction to hear a private action for damages implied under Section 206 of the Investment Advisers Act, and, if so, whether such a claim lies where there are no actual damages?

COUNTERSTATEMENT OF FACTS

Plaintiff Robert Abrahamson is a licensed medical doctor. His wife, Marjorie Abrahamson, is a former vice president and stockholder of Foote, Cone & Belding, a large New York City advertising agency. They became limited partners in The Fleschner Company, a limited partnership composed of a small number of friends and relatives of the defendant Malcolm K. Fleschner (32a), on or about July 1, 1965 (129a). On April 1, 1966, the name of the partnership was changed to Fleschner Becker Associates, after the defendant William J. Becker became a general partner and a number of his friends and relatives also became limited partners. When the Abrahamsons joined the partnership, they read and signed a written partnership agreement, which gave the general partners broad authority to invest the assets of the partnership as they deemed appropriate. That agreement

was later amended on two occasions: April 1, 1966 and October 1, 1968 (35a).

From the beginning, FBA was conceived, organized and empowered to invest in every kind of investment device (34a-35a). Thus, the original agreement of limited partnership, which recited its purpose to be the investment in "securities and investments of every kind and character," (34a) delegated broad investment powers to Fleschner, who was authorized to purchase, hold and sell a wide variety of investments (34a). The two succeeding amendments of the original partnership instrument retained provisions authorizing a wide scope of investment options and delegating broad discretionary investment authority to the general partners (34a-35a).

Pursuant to the authority granted by the partnership agreement, the general partners invested the assets of the partnership in a wide variety of investments, including securities which had not been registered with the Securities and Exchange Commission pursuant to the Securities Act of 1933, 15 U.S.C. §§ 77a et seq., and which were not, therefore, salable to the general public without registration. Some of these securities could be registered at the demand of FBA, and all were, in any event, salable without registration by private placement and were in many

instances sold by FBA to other private placement investors (238a).

It is undisputed that FBA's investments were highly successful. In 1967 and 1968,* the assets of the partnership increased by 122 percent and 90 percent, respectively, or an increase of more than 400 percent in two years. A substantial portion of this gain, which constitutes the basis for the Abrahamsons' purported claim of damages, was the result of FBA's purchases, and in many cases, sales, of unregistered securities (236a).

The Abrahamsons participation in FBA was extremely successful as the following table shows (111a):

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* Unless otherwise specified, references to years are to the fiscal year of the partnership, which ended on September 30. Thus, reference to 1967 means the fiscal year ending on September 30, 1967.

Robert Abrahamson

Date	Capital Contributions	Withdrawals
July 1, 1965	$150,000.00	
Sept. 30, 1967		$ 8,000.00
Sept. 30, 1968		32,500.00
Sept. 30, 1969		70,000.00
Sept. 30, 1970		45,500.00
Distributive share on withdrawal from the partnership		150,097.00
TOTALS	$150,000.00	$306,097.00

Net Profit $156,097.00

Marjorie Abrahamson

Date	Capital Contributions	Withdrawals
July 1, 1965	$180,000.00	
Oct. 1, 1966	2,652.22	
Sept. 30, 1967		$ 57,015.70
Oct. 1, 1967	266,847.13	
Sept. 30, 1968		58,000.00
Sept. 30, 1969		52,500.00
Sept. 30, 1970		73,500.00
Distributive share on withdrawal from the partnership		$341,565.00
TOTALS	$449,499.35	$582,580.70

Net Profit $133,081.35

Joint Totals	$589,499.35	$888,677.70

Joint Profit $299,178.35

The Abrahamsons withdrew from the partnership on September 30, 1970 (129a). When they did so, their total

withdrawals exceeded their investment by $289,178.35 (111a).

COUNTERSTATEMENT OF THE CASE

On January 25, 1971 the Abrahamsons instituted this action to recover an additional profit of $1,254,800, which, they claim, is the difference between what they would have received had they withdrawn from the partnership on September 30, 1968 and what they actually received when they withdrew on September 30, 1970. Their complaint alleged violations of Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), and of Rule 10b-5 promulgated thereunder, and of Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6. Federal jurisdiction was allegedly based upon Section 27 of the 1934 Act, 15 U.S.C. § 78aa, and Section 214 of the Investment Advisers Act, 15 U.S.C. § 80b-14.

On January 25, 1974 defendants moved for summary judgment pursuant to Rule 56 of the Federal Rules of Civil Procedure on the ground, inter alia, that as a matter of law the plaintiffs had suffered no injury which entitled

them to the recovery of damages.* In their papers opposing the defendants' motion for summary judgment and supporting their own motion for summary judgment, the plaintiffs claimed that, despite having made a handsome profit on their investment, they were entitled to an additional recovery in excess of $1,254,800 because they would, allegedly, have withdrawn from the partnership in 1968 had they been advised of the extent of the partnership's investments in unregistered securities. Only passing reference was made to the theory on which they now rely -- that the revision of the partnership agreement in late 1968 constituted a "purchase or sale" of a security within the meaning of Section 10(b). Instead, they relied almost entirely on the theory that they were entitled to recover the difference between the value of their investment in the partnership on September 30, 1968 and the

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* Since Judge Carter did not reach the other grounds urged in support of the defendants' motion for summary judgment, described at page 5 of the appellants' brief, those points are not in issue on this appeal. Nor is Judge Carter's denial of plaintiffs' motion for summary judgment, which, although appealed, was not briefed. See Brief for Appellants at 46:

> "For the foregoing reasons, the order and judgment of the District Court granting defendants' motions for summary judgment dismissing the complaint should be reversed and the case remanded for further proceedings."

amount which they ultimately received when they withdrew on September 30, 1970.

Judge Carter, in a carefully reasoned and thoughtful opinion rejected this contention and granted summary judgment to the defendants (290a). 392 F. Supp. 740 (S.D.N.Y. 1975).

On this appeal the plaintiffs have largely abandoned their contention that their failure to withdraw from the partnership in 1968 constituted a "sale" for purposes of Section 10(b) and have shifted their reliance to the hitherto undeveloped claim that their signing of an amended partnership agreement in late 1968 or early 1969 constituted a $1.7 million "purchase" of a security.

POINT I

THE COURT BELOW CORRECTLY APPLIED THE "OUT-OF-POCKET" DAMAGE RULE IN GRANTING SUMMARY JUDGMENT

In Point II of their brief, plaintiffs return to what was, before their loss below, the centerpiece of their argument. Their principal contention before the District Court, a contention which in no way rested on the spurious constructive purchase theory now emphasized, was that the Supreme Court's holding in Affiliated Ute mandates their recovery of damages measured as if they had withdrawn from FBA in 1968, the date when their partnership shares reached peak value.

The Abrahamsons do not claim there was fraud in connection with their investment in the partnership in 1965. They do not claim there was fraud in connection with their withdrawal in 1970. All they say is that, had they been advised of the partnership's investment in unregistered securities, they would have withdrawn at the top of the market in 1968, thereby reaping the benefit of those very investments without suffering the effect of the subsequent market decline. This is precisely the type of *ex post facto*, benefit-of-hindsight claim, virtually irrefutable from objective facts, which the Supreme Court sought

to foreclose in Blue Chip Stamps v. Manor Drug Stores, 43 U.S.L.W. 4707, 4713-15 (June 9, 1975) (hereinafter "Blue Chip"). Strained theories of constructive purchases and sales, such as advanced by the plaintiffs, ought not to be permitted to undermine the Supreme Court's purpose or the traditional out-of-pocket damage limitation in Section 10(b) cases.

The District Court held that the plaintiffs were barred from asserting a claim under the federal securities laws because they had suffered no out-of-pocket loss. In reaching this conclusion, the court acted in accordance with the congressional dictates of Section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a), and correctly applied damage rules applicable under Section 10(b).

The issue of damages in this case is not factually complex. There is no dispute that the plaintiffs' withdrawals from FBA exceeded their contributions by $289,178. Likewise, there is no dispute that "defendants have not been enriched as a result of their allegedly fraudulent conduct and have no profits to disgorge" (Opinion of Judge Carter, 309a). Plaintiffs do not claim that the failure to itemize FBA's security holdings in the Goodkin financial statements or

any other omission was a deliberate act of concealment. Finally, there is no dispute that the partnership's investments in the unregistered securities of which plaintiffs now complain accounted for much of the $289,178 profit plaintiffs actually realized and much of the "paper profit" which they seek to recover.

The factual simplicity of this issue, however, is in stark contrast to plaintiffs' muddled legal theories. The difficulty appears to arise from their efforts to use case language which, taken out of context, appears to be applicable to the facts of this case but which, when closely read and logically analyzed, is demonstrably irrelevant.

Plaintiffs cite and extract operative language from cases involving a simultaneous disparity in the price paid or received by plaintiff and the value received or surrendered and suggest that such cases govern this dispute. However, this case concededly involves no such disparity. The Abrahamsons make no claim that their investment in FBA when they became partners in 1965, that is, when they allegedly "purchased" their participation (either then or on the occasion of later additional contributions to capital, which occurred up to October 1, 1967), was worth less than what they contributed. Nor do they claim that when they withdrew from FBA in 1970 their interests were worth more or less

than what they received. Finally, they do not claim the value of their partnership interests in 1968 was under- or over-stated. In fact, they underscore the correctness of that valuation by <u>claiming damages based on that valuation</u>. Thus, the Abrahamsons are not in the position -- common to all of the cases on which they rely -- of claiming that they were induced to pay too much, or sell for too little, because of the defendants' alleged fraud.

The anomaly inherent in this situation -- of plaintiffs who do not claim that they ever received less than they paid for or paid more than the value of what they received -- underscores the extent to which the plaintiffs seek to utilize a misreading of the Supreme Court's decision in <u>Affiliated Ute</u> to undermine the "in connection with" requirement reaffirmed by the Supreme Court in <u>Blue Chip</u>.

A. <u>Affiliated Ute</u> Does Not Support The <u>Plaintiffs' Theory of Damages</u>

Plaintiffs rely heavily on a carefully-edited excerpt from <u>Affiliated Ute</u>, an excerpt which, as edited, appears to lend some support to their argument that they are entitled to recover the amount by which the value of their partnership interests declined between September 30, 1968 and September 30, 1970. The edited version, as it appears in plaintiffs' brief (at 35), is indeed somewhat ambiguous and subject to dual interpretations:

"'In our view, the correct measure of damages under § 28 of the Act . . . is the difference between the fair value of all that the . . . seller received and the fair value of what he <u>would have received had there been no fraudulent conduct</u> . . . ' (Emphasis added.)"

The entire paragraph, however, is not ambiguous, especially in light of the factual context of the case and the extremely material citations:

"In our view, the correct measure of damages under § 28 of the Act, 15 U.S.C. § 78bb(a), is the difference between the fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct, see Myzel v. Fields, 386 F.2d 718, 748 (CA8 1967), cert. denied, 390 U.S. 951 (1968), except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit. See Janigan v. Taylor, 344 F.2d 781, 786 (CA1 1965), cert. denied, 382 U.S. 879 (1965)." 406 U.S. at 155.

Reference to the entire paragraph, the two cases cited and the facts of Affiliated Ute confirms that the Court, when it used the words underscored by plaintiffs, did not intend to abandon or weaken the out-of-pocket damages rule or to free it from the "in connection with" requirement, which was unquestionably satisfied and not in issue in that case.

In Affiliated Ute, white stock transfer agents devised a scheme to acquire from mixed-blood members of the Ute tribe, at less than fair value, shares in certain property. The transfer agents were simultaneously making

a market among non-Indians at prices ranging from $500 to $700 per share and inducing the Indians to sell at prices from $300 to $700 without disclosing to the Indians the disparity. Thus, the selling mixed-blood Utes were clearly receiving less than the fair value of their shares at the time of sale, i.e., what they "would have received had there been no fraudulent conduct." The Court, in using the words on which plaintiffs base their entire case, was unmistakably merely reiterating the out-of-pocket theory: a defrauded seller is entitled to recover the difference between the actual value of what he sold and what he received, measured at the time of sale. Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971). See Note, The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities, 26 Stan. L. Rev. 371, 383-85 (1974).

The continuation of the Affiliated Ute paragraph, omitted from plaintiffs' brief, is superfluous when read as plaintiffs urge. The Court continued:

> "except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit. See Janigan v. Taylor, 344 F.2d 781, 786 (CA1 1965), cert. denied, 382 U.S. 879 (1965)",

thus endorsing the procedure in Janigan of awarding a defrauded seller, in addition to his out-of-pocket loss, i.e.,

the difference between value surrendered and value received (referred to as "the seller's actual loss" in the Court's opinion), any excess over fair value at the time of sale which the defrauding buyer realized on resale. For example, if a fraud-tainted sale occurs at a price of $10 when fair market value is $15, and the defrauding purchaser resells for $20, the seller's out-of-pocket damages ("actual loss" in the Court's opinion) are $5; the price obtained by defendant on resale is irrelevant to the traditional measure. However, the defendant has "received [a profit of $10, or $5] more than the seller's actual loss [of $5]." In a <u>Janigan</u> situation, as reaffirmed by <u>Affiliated Ute</u>, the "damages are the amount of the defendant's profit", in effect, restitution of the fruits of the fraud.*

In <u>Janigan</u>, the Court rejected the defendants' argument that damages in excess of the out-of-pocket measure would involve the Court in speculating as to what the plaintiffs would have done had the unknown facts been disclosed

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* This Court has similarly interpreted <u>Janigan</u> and <u>Affiliated Ute</u>:

> "These cases hold that a defrauded seller suing the purchaser for violation of the federal securities laws may recover the profits obtained by the purchaser with respect to the securities." <u>Gerstle v. Gamble-Skogmo, Inc.</u>, 478 F.2d 1281, 1304 (2d Cir. 1973) (Friendly, C.J.).

to them. In effect, the Court adopted a conclusive presumption that the plaintiffs there would have done exactly as did defendant, i.e., resold at the price received by defendants, and fashioned damages accordingly, thus neatly and simultaneously solving two problems: avoidance of speculation as to what the plaintiffs' conduct would have been "but for" the fraud and depriving the defendant of his wrongful gain.

Plaintiffs' reading of Affiliated Ute as applied to this case would destroy this symmetry and create precisely the kind of speculation and uncertainty condemned by the Supreme Court in Blue Chip. First, the court would be required to speculate as to the "fair value of what [the plaintiffs] would have received had there been no fraudulent conduct," not with respect to fair value at the time of sale, which is the accepted method of measuring damages, but at some unknown, undefined and non-ascertainable time in the future. Although herein, the amount of plaintiffs' capital account at any given point in time is not at all speculative, having been, necessarily, calculated at the end of each FBA fiscal year, the timing of their withdrawal is totally speculative. There is only plaintiffs' hindsight claim that they would have withdrawn when their shares were at peak value.

Second, the _Janigan_ symmetry is not present here because, as conceded and found by the District Court, the defendants have no wrongful gain to disgorge.* In fact, just the opposite is true; had plaintiffs withdrawn in 1968, the general partners would have received $178,152, or 20 percent of the unrealized capital gains credited to plaintiffs' capital account (236a).**

Third, had the Court in _Affiliated Ute_ intended to permit the type of recovery sought by the Abrahamsons in this case, it would not have limited the defendants' expanded liability to profits obtained upon their resale of the shares, but would have required the defendants in addition to compensate the plaintiffs for any further increase in value after the defendants' sale to third parties. Of course, the Court rejected any such result because of its speculative character, and _Blue Chip_ reaffirms that position.

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* Plaintiffs' brief (at 42) leaves the impression that the general partners of FBA earned management fees for their administration of partnership affairs. This is manifestly not true. The general partners, all of whom placed their entire fortunes at risk with FBA, received as a group only 20% of the partnership _gains_, in addition to a normal partner's participation (71a, 94a).

** Article 5 of the governing 1966 partnership agreement (72a-73a).

B. Blue Chip Bars The Plaintiffs' Claim Because They Were Neither Defrauded Purchasers Nor Sellers

In Blue Chip the Supreme Court reaffirmed and clarified the rule enunciated by this Court in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952), that "the plaintiff class for purposes of a private action under Section 10(b) and Rule 10b-5 was limited to actual purchasers and sellers of securities" and should not be extended to include investors who, like the Abrahamsons, claim with the benefit of 20-20 hindsight that they would have bought or would have sold securities if only they had been informed of some allegedly material fact. 43 U.S.L.W. at 4709-12. The Abrahamsons' claim that they would have withdrawn from the partnership in 1968, if only they had been advised that their substantial paper profit had been obtained through investments in unregistered securities, falls squarely within the four corners of Blue Chip and is, thus, directly governed by the Court's holding in that case.

Fundamental to the Court's reasoning in Blue Chip was its recognition that elimination of the purchase or sale requirement of Section 10(b) would result in purely speculative damage claims based on unsubstantiated, subjective oral testimony that the plaintiff would have bought or sold, when he did not in fact buy or sell, if only he had been aware of

some fact which, in hindsight, might appear relevant, 43 U.S.L.W. at 4714, and it was to avoid precisely this sort of speculative damage claims that the Court reaffirmed Birnbaum.

What the plaintiffs are asking this Court to do is to reject Blue Chip in the guise of extending damage theories to include non-sales and non-purchases, and thus to eliminate by the back door the actual purchaser and actual seller rule reaffirmed in Blue Chip. This, of course, the Court cannot and should not do. Decided case law limits recovery in any Section 10(b) action to actual damages and does not permit speculation and surmise.

C. Applicable Case Authority Squarely Establishes That Plaintiffs Cannot Recover Damages Where They Suffered No Loss And Defendants Made No Profit

Plaintiffs, having seen their partnership shares reach peak value in 1968, now claim damages based on that peak value. They make this claim despite the fact that they profited handsomely from their FBA investment and without any allegation that when they bought or sold their FBA shares (plaintiffs claim they are either defrauded buyers, or sellers, or both) those shares were over- or under-valued.* They thus cannot show any actual damages. The

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* Plaintiffs claim they were either defrauded purchasers in 1968 or defrauded sellers in 1970, but do not claim that in 1970 their partnership shares were worth more than they received on withdrawal. Plaintiffs perforce do not claim their partnership shares in 1968 were worth less than they were valued by FBA since they seek damages based on that valuation.

law is clear that they have no Section 10(b) claim under such circumstances.

Plaintiffs' first attempt is made by claiming that the interim withdrawals from their capital accounts should not be counted in computing whether they profited from their participation in FBA. Their attempt to characterize these withdrawals as some sort of distribution of partnership income and therefore somehow different is simply misleading. Each of their withdrawals from the FBA pool of assets -- a pool comprised of all FBA investments plus the return earned thereon -- reduced their partnership percentages. The partners, by agreement, were not paid a return on their participation; they merely participated in all partnership profits and losses in proportion to their share.

In addition, as Judge Carter stated,

> "all payments to plaintiffs, be they considered dividends or interest, must be counted in determining the amount of actual loss that can be recovered in Section 10(b) litigation" (Opinion of Judge Carter, at 11 (301a)).

The cases cited and analyzed by the District Court amply demonstrate the precedential soundness of this holding. See Opinion of Judge Carter, at 11-13 (301a-303a)

Section 10(b) cases firmly establish that there is no cause of action where there is no actual damage.

In Madigan, Inc. v. Goodman, 357 F. Supp. 1331 (N.D. Ill. 1973) the court squarely confronted this question and, after reviewing the applicable authorities, held that the out-of-pocket damage rule precludes a Section 10(b) claim even where the allegedly defrauded purchaser merely broke even in the purchase and sale of a security.

> "It is the opinion of this Court that since the plaintiffs have resold the securities purchased from the defendants for the same price at which those securities were acquired, plaintiffs have suffered no loss and thus have no cause of action." Id. at 1331. (Emphasis added).

The court elaborated as follows:

> "It is well settled that the failure to show actual damages is a fatal defect in bringing a cause of action based on the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. . . . [T]he federal rule of damages for such fraud is an 'out of pocket rule', the difference between the amount parted with and the value of the thing received. Smith v. Bolles, 132 U.S. 125, 10 S.Ct. 39, 33 L.Ed. 279 (1889); Sigafus v. Porter, 179 U.S. 116, 21 S.Ct. 34, 45 L.Ed. 113 (1900); Hindman v. First National Bank, 112 F. 931 (6th Cir. 1902), cert. denied, 186 U.S. 483, 22 S.Ct. 943, 46 L.Ed. 1261; Tooker v. Alston, 159 F. 599 (8th Cir. 1907); Chandler v. Andrews, 192 F. 543 (2nd Cir. 1911); Nashua Savings Bank v. Burlington Electric Lighting Co., 100 F. 673 (S.D. Iowa 1900); Morris v. United States, 303 F.2d 533 (1st Cir. 1962); Mott v. Tri-Continental Financial Corporation, 330 F.2d 468 (2d Cir. 1964)." Id. at 1333-34.

Finally, the court added a comment particularly applicable to the instant case:

> "It is clear that the question of damages turns not on what the plaintiffs might have gained, but what has been lost by being allegedly deceived into a purchase. . . . It is clear that liability does not include the speculative fruits of unrealized profit." Id. at 1335.

Both plaintiffs have received more than their investment in the partnership, neither has suffered any "out of pocket" loss or "actual damages" at any time, and they therefore have no cause of action.

Plaintiffs' situation is similar to the corporation on whose behalf a derivative Section 10(b) action was brought in Cohen v. Colvin, 266 F. Supp. 677 (S.D.N.Y. 1967). The court granted defendants' motion for summary judgment stating that "all indications point to the fact that rather than sustaining damages, the corporation benefited from the actions of the defendants." Id. at 683.

Although plaintiffs might have increased their profit by withdrawing at the end of fiscal year 1968, and although the fact they did not then withdraw is understandably disappointing for them, Section 10(b) does not give them a claim for profits as of a date on which they neither bought nor sold and where, in any event, they profited.

The Court below observed that the claim of plaintiffs is precluded by this Court's decision in a remarkably similar case. In Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971)

(Friendly, C.J.), a former preferred shareholder of defendant corporation alleged that the corporation had, several years after his purchase of redeemable preferred shares, falsely represented that it would exchange 6-1/2 shares of common stock for each share of preferred. The price of preferred shares rose to reflect the anticipated exchange* but plaintiff did not sell, choosing instead to await the exchange. The preferred shares were redeemed, rather than exchanged, at a price lower than that for which plaintiff could have sold his shares on the market. Exactly like plaintiffs herein, Levine claimed damages based on the difference, on the theory that he had been misled into retaining stock and that he

> "was entitled to what he could have realized if he had sold his preferred stock at the inflated prices prevailing during the summer of 1968. . . ." Id. at 333.

This Court flatly rejected that assertion -- an assertion identical to the Abrahamsons':

> "Under the 'general' laws regime of Swift v. Tyson, 41 U.S. (16 Pet.) 1, 10 L.Ed. 865 (1842), the rule in the federal courts was that a defrauded buyer of securities is entitled to recover only the excess of what he paid over the value of what he got, not, as some other courts had held, the difference between the value of what he got and what it

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* The preferred shares had been trading at a price lower than the redemption price. 439 F.2d at 333 n.6.

was represented he would be getting, Smith v. Bolles, 132 U.S. 125, 10 S.Ct. 39, 33 L.Ed. 279 (1889); Sigafus v. Porter, 179 U.S. 116, 21 S.Ct. 34, 45 L.Ed. 113 (1900). This also is the governing rule under Rule 10b-5 in cases of defrauded buyers. See Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10 Cir. 1962); Janigan v. Taylor, 344 F.2d 781, 786 (1 Cir.), cert. denied, 382 U.S. 879, 86 S.Ct. 163, 15 L.Ed.2d 120 (1965); 2 Bromberg, Securities Laws: Fraud-SEC Rule 10b-5, § 9.1 at 226-27 (1969); 6 Loss, Securities Regulation 3923 (1969). On the other hand a defrauded seller of securities has been allowed to recover under Rule 10b-5 not only the difference between the actual value and what he received at the time of sale, see Kohler v. Kohler Co., 208 F. Supp. 808, 825-826 (E.D.Wis. 1962), aff'd 319 F.2d 634 (7 Cir. 1963) (dictum), but added profits which the buyer has realized through accretions in value subsequent thereto, Janigan v. Taylor, supra, 344 F.2d at 786-787, or which the seller would have realized had he retained the stock for a reasonable period after the disclosure,[*] Myzel v. Fields, 386 F.2d 718, 744-747 (8 Cir. 1967), cert. denied, 390 U.S. 951, 88 S.Ct. 1043, 19 L.Ed.2d 1143 (1968); see generally Note, Insiders' Liability under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities, 78 Yale L.J. 864, 878-91 (1969)." Id. at 334.

The Court, in an excerpt quoted by Judge Carter below, reaffirmed the vitality of Section 28(a) of the 1934 Act:

"The plain fact is that save for the possibility of selling to an innocent victim, Levine lost nothing from Seilon's alleged fraud except the euphoria he doubtless experienced during the

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* Two years later this Court said that a defrauded buyer could also obtain windfall profits received by the defrauding party. See Zeller v. Bogue Electric Manufacturing Corp., 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973).

summer and fall of 1968. This does not constitute the 'actual damages,' see § 28(a), compensable under § 10(b) of the Securities Exchange Act or Rule 10b-5." Id. at 335 (emphasis added).

Likewise, the Abrahamsons have not suffered the actual damages compensable under Section 10(b). The dismissal below should be affirmed.

D. Plaintiffs' Authority Is Clearly Inapposite

The plaintiffs are perfectly consistent in their citation of clearly inapposite case precedent and in their editing of quotations to alter their meaning.

For example, the plaintiffs cite Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), and suggest that it is somehow applicable to this case. It is obvious, however, that the case is, as plaintiffs concede, a Janigan-rule case in which the defendant, whose conduct was found after trial to have violated Section 10(b), was made to disgorge the profits which he obtained as the result of his fraudulent conduct. Plaintiffs herein neglect to mention that in Rochez Bros. the defendant had clearly profited handsomely from his material nondisclosures and misrepresentations, having purchased 50 percent of a corporation for \$598,000 and having later sold the entire corporation for \$4,250,000 plus 50,000 shares of stock. The Third Circuit applied Janigan and Affiliated Ute and required the disgorgement by defendant of the profit realized on resale of the wrongfully acquired shares. The Court made clear the impact

of Affiliated Ute in a portion of its opinion which plaintiffs have overlooked:

> "However, the clear intent of the Ute rule of damages, read in its entirety and in light of Janigan, is to give a defrauded seller the benefit of whichever measure of damages provides the greater recovery: either the difference between the sale price of the stock in the fraudulent transaction and its fair market value at that time or the amount of the fraudulent buyer's profit on resale." 491 F.2d at 417 (emphasis added).

It is clear that neither measure of damages affords the Abrahamsons a right of recovery since they do not claim any disparity between the value given and the value received at the time of sale and they do not claim that the defendants obtained any profit.

Plaintiffs next discuss another Janigan-rule case, Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969), cert. denied, 396 U.S. 1037 (1970), and attempt to characterize it as a case in which

> "it does not appear that the defendants realized the gain of which plaintiff was deprived" (Brief for Appellants, at 40).

This statement, although accurate in the sense that defendants had not sold (i.e., "realized the gain" on) the wrongfully acquired shares, is disingenuous in its attempt to imply that defendants had no profit to disgorge. Defendants there still held the fraudulently purchased stock which had, since

the fraud-tainted purchases, increased from 1000 shares to 138,400 shares as a result of two stock splits: the first 34.6 to 1, the second, 4 to 1. These 138,400 shares, which were purchased from plaintiffs before the stock splits for $20,000, were trading, shortly before the District Court's decision, at 8 1/2, making them worth some $1,176,400. This was basically, then, nothing other than a classic Janigan case in which defendants were made to give up the fruits of their deception. Janigan is cited, indeed dwelled upon, in both the District Court and the Third Circuit opinions.

The plaintiffs also misconstrue Bird v. Ferry, 497 F.2d 112 (5th Cir. 1974). In that case a securities salesman was held liable both on common-law fraud grounds for embezzlement and under federal securities laws for having converted the club's assets, while covering his tracks by furnishing the club members regular and detailed statements of their ghost portfolio. The Fifth Circuit, on appeal by the salesman's employer, a brokerage firm, approved an award of damages based on the final value of the ghost portfolio as represented to plaintiff by the salesman. Reference to the sentence immediately following the excerpt in plaintiffs' brief demonstrates that plaintiffs once more omit a material portion of a quoted passage which in this case makes amply

clear that the Court was relying on Georgia common law in approving what was essentially a restitution of converted assets. Plaintiffs' excerpt, with the additional sentence underscored reads:

> "We see nothing inappropriate in the court's use of a measure of damages calculated to restore the club to the position it would have occupied had the defalcations not occurred. Nor, more importantly, are we cited to any Georgia case to the contrary." 497 F.2d at 113.

It is thus clear that the Court's measure of damages reasoning rested on state law fraud precedent, not Section 10(b)

Plaintiffs' reference to Zeller v. Bogue Electric Manufacturing Corp., 476 F.2d 795 (2d Cir. 1972) (Friendly, C.J.), is, once again, inapposite and the quotation excerpted by plaintiffs is, once again, abruptly abbreviated. Plaintiffs fail to mention that this is a defrauded buyer case in which the defendant corporation profited from the fraud (by virtue of an inexpensive loan from Belco, the corporation of which plaintiff was a shareholder). As for the excerpt of this Court's opinion used in plaintiffs' brief, defendants refer

the Court to the remainder of that footnote set forth below.* At most that footnote merely says that a defrauded purchaser may, in certain extreme circumstances, be permitted to trace the property received by the fraudulent seller if the fraudulent seller made additional profits and the assets can be traced with sufficient certainty. However, since there is no claim here that the defendants profited in any way from the plaintiffs' alleged loss, <u>Zeller</u> is clearly not in point.

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* "Restitution seems to be based not only on a feeling that the party who has acted wrongfully should not be permitted to benefit from his conduct but also that the injured party should be given the benefits of a transaction he would otherwise have been in a position to enter into. [Plaintiffs' excerpt ends here] <u>The latter consideration is more likely to be present in a securities fraud case where the defrauded party is a seller and the defrauding buyer has subsequently sold the fraudulently acquired securities at a profit</u>, since the higher market price would have been as much of an inducement to the defrauded party to sell the securities as it was to the defrauder. When the defrauded party is a buyer, and the defrauding seller uses the proceeds of a sale to enter into a second profitable transaction, it is far more difficult to say as a general proposition that, if the fraud had not occurred, the defrauded party would also have done this. Nevertheless, absent unusual circumstances, when a buyer has been induced to surrender consideration because of the fraudulent conduct of a seller, it seems appropriate to require the seller to disgorge any profits he would not otherwise have been in a position to realize if these can be traced with sufficient certainty. Compare Restatement of Restitution § 150 (1937), with <u>id</u>. § 202." 476 F.2d at 802 n. 10 (emphasis added).

Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971), is cited by plaintiffs even though the Tenth Circuit was careful in that case to limit Texas Gulf's application to its facts, and even though the case involved plaintiffs misled into selling and who sought a measure of damages based on the cost of reinvestment, a logical way of determining the difference at the time of the sale between the value received upon the sale and the value of the securities sold. Judge Carter rejected the plaintiffs' attempted reliance below on Texas Gulf. Opinion of Judge Carter, at 17-18 (307a-308a).

The very excerpt in plaintiffs' brief from Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973) (Friendly, C.J.), demonstrates that it, like so many of plaintiffs' other inapposite cases, is a Janigan-rule case, wherein defendant profited, following the fraud-tainted merger, from sales of the acquired properties. Furthermore, the excerpt quoted by plaintiffs is not this Court's holding, but merely a "second rationale that provides the support for plaintiffs' further argument that the award should be based on the highest intermediate value of the assets of GOA between the date of the merger and the date of judgment." Id. at 1305. This Court rejected plaintiffs' argument as "too simple" and because the conclusion which the Court was asked to reach was, in

the District Court's language which this Court quoted, "too untenable and speculative to support an award of damages." Id.

Plaintiffs have thus failed to set forth a single case awarding a plaintiff more than his out-of-pocket damages where the defendant did not in some way receive gain or profit as a result of plaintiffs' alleged "loss." Plain tiffs' lost gain here is the result of a decline in value of FBA's assets which occurred during a general and pervasive market decline. Neither FBA nor its general partners profited from this decline -- the value of everyone's shares declined from the 1968 high point and every member of FBA suffered a loss of "the euphoria he doubtless experienced during the summer and fall of 1968." Levine v. Seilon, 439 F.2d 328, 335 (2d Cir. 1971). That plaintiffs are members of this disappointed group does not -- and defendants submit should never -- give plaintiffs the right to receive the highest value of their partnership interests at the expense of their fellow losers.

POINT II

PLAINTIFFS' NEW "CONSTRUCTIVE PURCHASE" DAMAGES THEORY IS TOTALLY WITHOUT LEGAL PRECEDENT AND CANNOT OVERRULE THE ACTUAL DAMAGES LIMITATION

Having apparently recognized the frailty of their claim that ordinary Section 10(b) damage principles entitle them to "paper profits" of $1,254,800, plaintiffs, in their brief on appeal, seek for the first time to utilize their consent to minor revisions of the FBA partnership agreement (revisions which for the most part benefited them) to transform their $289,178 profit on their investment in FBA into a $1,254,800 securities law claim for damages. For reasons clearly and immediately evident, plaintiffs' attempted transformation must fail.

Defendants submit that the only issue properly before this Court is the issue correctly viewed as dispositive by Judge Carter: whether these profiting plaintiffs, having suffered no actual damages or out-of-pocket loss, may nevertheless maintain a Section 10(b) claim for "damages." Plaintiffs have largely abandoned the theory they relied on below and have devoted the bulk of their brief in this Court to the newly-raised argument that the revision of the FBA partnership agreement in 1968 amounted to a "constructive purchase" of securities that entitles them to measure damages from the high point of their partnership interest's value.

The plaintiffs' belated reliance on the 1968 revisions of the FBA partnership agreement ("1968 revisions") itself persuasively demonstrates the lack of merit in their current claim. There is no allegation whatsoever in the Abrahamsons' complaint (4a) suggesting that, even at the time they filed their complaint, they viewed the 1968 revisions as involving a significant investment decision for them, that is, as amounting to a "purchase or sale" for purposes of Rule 10b-5; in fact, the complaint does not even mention the 1968 revisions. The Abrahamsons' principal argument on this appeal is thus addressed to, and based upon, facts and legal theories never alleged in their pleadings. This alone is fatal to their case. Browning Debenture Holders' Committee v. DASA Corp., [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,[illegible]71 at 97,753-54 (S.D.N.Y. 1975).

Furthermore, plaintiffs never raised the 1968 revisions until the cursory reference included in their reply brief in opposition to defendants' motion and, even then, the contention was not, as now, addressed to the damages issue but to the "in connection with" discussion in defendant Goodkin's brief.* The subject of the 1968 revisions was

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* The short excerpt of the plaintiffs' brief below quoted in the Brief for Appellants (at 30), suggesting that it was "possible to view" the plaintiffs' consent to the 1968 revisions as a "purchase," was the sole discussion below addressing the issue upon which plaintiffs now rely.

entirely omitted from plaintiffs' own affirmative motion for summary judgment, although plaintiffs now seek to use the argument affirmatively. The conclusion is therefore inescapable that plaintiffs' shift of theories results not from the substance of their 1968 "investment decision" but from their recognition that the decision below was correct.

In addition to the fact that this issue was not properly raised below, the plaintiffs' eleventh-hour reliance on the revision of the 1968 partnership agreement as constituting a purchase of securities for Section 10(b) purposes is wholly misplaced.

First, plaintiffs seek to avoid the damages question by proffering inapposite, non-Section 10(b) case authority which discusses "purchase" in a jurisdictional or standing, not damages calculation, context. Decisions interpreting the jurisdictional scope of the various securities laws, however, in no way touch the actual damages limitation, which plaintiffs would have this Court overrule sub silentio.

Second, whether or not plaintiffs' new constructive purchase theory is accepted, it is plain that the circumstances of this case rule out its application here. The 1968 revisions were substantively insignificant, being

for the most part beneficial to the limited partners. The plaintiffs' consent to them cannot be considered, in view of solid precedent and common sense, a constructive "purchase" of $1.7 million of securities.

Third, plaintiffs' new theory is squarely contradicted by the Blue Chip opinion in which the Supreme Court explained why claims under Section 10(b) must be limited to actual purchasers and actual sellers; "constructive" purchase and sale bootstrapping was emphatically rejected.

Defendants submit that, viewed in this light, it is evident that plaintiffs' theoretical formulation must fail and that Judge Carter's order granting the defendants' motion for summary judgment was manifestly proper.

A. Plaintiffs' Novel Damages Proposition Is Totally Unsupported By Precedent and Common Sense and Is Squarely Controverted By Section 10(b) Authority

The authority set forth in plaintiffs' Point I simply does not support their argument that signing the 1968 partnership agreement should be viewed as constituting a constructive purchase of $1.7 million in securities for purposes of calculating damages in a Section 10(b) action.

Not only have plaintiffs cited no Section 10(b) case in which a constructive purchase has been used to calculate damages, they have failed to, and cannot, cite

any securities case in which their novel theory has been so applied. Each of the five cases they do cite (only one of which is a 1934 Act case) was concerned with the question of the jurisdictional reach of the statute, not damages. That is, in each case the question considered was whether the specific transaction at issue was jurisdictionally within the various statutes at all as being a "purchase" or "sale," not whether the constructive purchase device was appropriate for the calculation of damages, even though in direct contravention of the traditional damage limitations in Section 10(b) cases. Moreover, each of plaintiffs' cases involved alterations to the underlying investment contract far more substantial than the 1968 modifications in the FBA partnership agreement.

The Supreme Court has clearly admonished that whatever numerous meanings the terms "purchase" or "sale" may have in the galaxy of federal securities laws, they must be construed, in a Section 10(b) case, only in the context of Section 10(b).

> "Although the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen, ordinary rules of statutory construction still apply. The meaning of particular phrases must be determined in context, _SEC v. C. M. Joiner Leasing Corp._, 320 U.S. 344, 350-351 (1943). Congress itself has cautioned that the same words may take

on a different coloration in different sections of the securities laws . . . . We must therefore address ourselves to the meaning of the words 'purchase or sale' in the context of § 10(b). Whatever these or similar words may mean in the numerous other contexts in which they appear in the securities laws, only this one narrow question is presented here." SEC v. National Securities, Inc., 393 U.S. 453, 466 (1969)*.

Following this rule, the Court refused to apply to the Section 10(b) question before it a definitional rule promulgated by the SEC pursuant to the 1933 Act.

Four of the five cases urged on this Court by plaintiffs are thus clearly inapposite to an interpretation of Section 10(b) and may be immediately dismissed from consideration. None of the cases except Ingenito v. Bermec Corp., 376 F. Supp. 1154 (S.D.N.Y. 1974), address Section 10(b), or even the

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* Accord, In re Penn Central Securities Litigation, 494 F.2d 528, 535 n.8 (3d Cir. 1974):

> "We do not find apposite the cases which have construed the word 'sale' in the context of § 16(b) of the 1934 Act, which relates to profits on short-swing sales. SEC v. National Securities, Inc., [supra]; International Controls Corp. v. Vesco, [490 F.2d 1334, 1344-45 (2d Cir. 1974)]".

This Court International Controls Corp. quoted with approval the above excerpt from National Securities.

1934 Act.* It is therefore difficult to perceive in what manner the application to this case of Associated Gas is "clear and direct," as claimed by plaintiffs (Brief for Appellants, at 20). Associated Gas is irrelevant.

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* Furthermore, as noted supra, each is distinguishable on its facts.

SEC v. Associated Gas & Elec. Co., 24 F. Supp. 899 (S.D.N.Y.), aff'd, 99 F.2d 795 (2d Cir. 1938), involved a determination under the Public Utility Holding Company Act whether the extension of a bond maturity date (a classic legal event to the obvious detriment of the bondholders) constituted the issuance of a new security. The opinion of this Court explicitly differentiates between its finding of a "new issue" under the Holding Company Act and a 1934 Act rule finding no new issue under that Act. Id. at 798.

United States v. Wernes ["Werner" in plaintiffs' brief passim], 157 F.2d 797 (7th Cir. 1946), and United States v. Riedel, 126 F.2d 81 (7th Cir. 1942), both involved criminal prosecutions for mail fraud and 1933 Act violations. Riedel seems to say only that a "sale" may include an exchange of property, a proposition not relevant to this case, since no exchange of property is involved here. The Wernes opinion says no more than Riedel because of its failure to explore the differences in the securities exchanged by defendants.

United States v. New York, N.H. & H.R.R., 276 F.2d 525 (2d Cir.), cert. denied, 362 U.S. 961 (1960), involved a determination under the Interstate Commerce Act whether the issuance of a security by the railroad under that Act (requiring ICC approval) would be found where a repurchase agreement relating to preferred shares was amended to: (1) postpone a dividend obligation, (2) postpone and alter the terms of a put, (3) accelerate and alter the terms of a call, and (4) change the put or call price under certain contingent circumstances. 276 F.2d at 529. These truly were "significant changes," classical financial events, unlike the minor modifications at issue here.

The Court in Ingenito made clear no fewer than three times that the question before it was one of jurisdiction; the question of damages was not raised at any point in the lengthy opinion. Ingenito, thus, is not authority that a constructive purchase, even if it may be viewed as a basis for statutory coverage, also is relevant to the determination of damages.

In any event, it is clear that Ingenito would not support the finding of a constructive purchase herein, even for jurisdictional purposes. The several complaints in Ingenito alleged successfully that various transactions, including exchanges of dissimilar herdowner promissory notes, exchanges of herd maintenance contracts (with and without grants of additional cattle), and herdowner payments on cancellable maintenance contracts, established "threshold § 10(b) jurisdiction." 376 F. Supp. at 1182. An analysis of Ingenito reveals, however, that the exchanges in question in that case were far different from, and far more substantial than, the revisions of the FBA partnership agreement at issue here, and indeed required the investors to make significant investment decisions. Also, the question there was the sufficiency of the complaint and whether, for jurisdictional purposes, the transactions as alleged were within Section 10(b).

Thus, none of plaintiffs' cases support in any manner their theory that a constructive purchase should provide

a starting point for the calculation of damages. Plaintiffs' total lack of precedent is not at all surprising in view of the implications of their proposition. The Abrahamsons would have this Court adopt a holding which could support, _inter alia_, the award to a corporation's shareholders of a "put" to the corporation and its management (in practical effect a guarantee against any future market decline) on the occasion of every amendment of the articles of incorporation at the time of which there was an innocent nondisclosure, without any regard to whether a shareholder lost or profited on his investment, nor to whether the corporation or its management profited because of the shareholder's paper loss, nor to whether the allegedly undisclosed fact caused the subsequent market decline. Such an award, out of all proportion to the alleged harm and without any analogy in any field of law, is precisely what the Abrahamsons seek from this Court.

Such a theory is squarely contradicted by the authorities set forth in Point I of this brief. See pp. 10-32, _supra_.

B. The 1968 Revisions To The FBA Partnership Agreement Were Insubstantial and Not Adverse To The Plaintiffs' Interests And, As Such, Are Not Sufficient To Support Finding A "Constructive Purchase"

This Court need not reach the merits of plaintiffs' novel constructive purchase damages theory; it could in no event be applied to this case. The minor revisions of the FBA partnership agreement in 1968, grandly described in plaintiffs' brief (at 14) as a "comprehensive revamping" of the agreement, were in fact no more than an administrative reorganization which left untouched the fundamental structure, goals and business operations of FBA. The revisions, most of which benefited the limited partners, simply do not support the inference that a "constructive purchase" occurred in 1968.

Plaintiffs' brief presents a table of what they describe as 16 of "the most pertinent changes" and urges expansively that the limited partners were, as a matter of law, compelled in 1968 to make "a new investment decision" because of the allegedly material differences between the 1966 and 1968 agreements (Brief for Appellants, at 14-17). That a decision of some sort was required may be so, but not every decision, not even every investment decision, which this decision manifestly was not, falls within the purview of Section 10(b).

In a recent decision, which is directly in point, the Third Circuit considered arguments virtually identical to those made by the plaintiffs here and held that, even for jurisdictional purposes only, there is no Section 10(b) "purchase" of a security unless the changes on which security holders are asked to vote amount to

> "in effect a major corporate restructuring requiring the same kind of investment decision by the shareholders as would a proposed merger with a separate existing corporation." In re Penn Central Securities Litigation, 494 F.2d 528, 534 (3d Cir. 1974).*

Under any interpretation of the facts the insignificant alteration of the FBA partnership agreement was

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* The Third Circuit noted that after oral argument had occurred in In re Penn Central Securities Litigation, this court filed its opinion in International Controls Corp. v. Vesco, 490 F.2d 1334 (2d Cir.), cert. denied, 417 U.S. 932 (1974), which considered a similar issue. 494 F.2d 528, 534-35 n. 7. In International Controls, assets changed hands. In distinguishing the case, the Third Circuit noted:

> "[i]n the instant case, however, the plaintiff shareholders retained control over the Railroad assets . . . and the remaining issue is whether their rights were otherwise substantially affected." Id. at 535 n. 7 (emphasis added).

Therefore, since there was no exchange of assets in this case, but merely a continuation of the partnership under a slightly revised partnership agreement, the inquiry here is therefore whether the limited partners' rights were "substantially affected" by the revisions.

not the kind of investment decision which the Third Circuit was describing in Penn Central.

Plaintiffs' assertion that "a new purchase of a security is deemed to have occurred" whenever "the contractual provisions of an investment relationship undergo material modification in any respect" (Brief for Appellants, at 17) is thus simply wrong. It is clear that the rights of the securityholder must be substantially and adversely affected, not just "materially modified in any respect." See p. 43n., supra. For the modifications to come within Section 10(b), they must have "significantly affected [the securityholders'] basic rights and interests." In re Penn Central Securities Litigation, 494 F.2d at 536. The modifications must

> "affect the basic stockholder decision on these matters in the same way as would 'a typical cash sale or share exchange.'" Id. at 537.

Clearly none of the modifications to the FBA partnership agreement described by plaintiffs in their brief, nor any other changes in the agreement, rise to this level.

By whatever yardstick one measures the significance of the "pertinent changes" set forth in plaintiffs' brief, it is clear that these revisions were not substantial, adverse alterations of the limited partners' rights, and did not affect the limited partners as would "a typical cash sale or merger."

The only term presented in plaintiffs' table that could possibly be said to have had any financial impact on the limited partners was No. 2, which authorized a $25,000 annual salary for the Managing Partners. The prospective impact of granting the general partners a modest salary, however, was obviously inconsequential. The salaries paid to all Managing Partners during fiscal 1969 amounted to only .0016 (sixteen-hundredths of one percent) of FBA's total assets (207a, 208a).

Plaintiffs suggest, in addition, that the modification of the "purposes of the partnership" section was a revision of great consequence and therefore produced a Section 10(b) "purchase" (Brief for Appellants, at 27).* However, precisely this assertion was considered and rejected as a matter of law by the Third Circuit in Penn Central Securities. There the plaintiffs argued that the added potential for diversification into non-railroad business which resulted from the reorganization of the Penn Central made each shareholder's decision on reorganization one involving "significant economic consequences" and thus brought the allegedly fraudtainted transaction within Section 10(b). The Third Circuit disagreed:

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* The original partnership agreement, in fact, stated that the partnership's purpose was to be the investment in "securities and investments of every kind and character" (34a, 39a).

"[W]e do not believe that this added potential for diversification brings the reorganization within the scope of the protection of the securities law. . . . [T]he added possibility of diversification was . . . in the nature of internal corporate restructuring." Id. at 538.

The Court noted that diversification can normally be accomplished by an amendment to the articles of incorporation with shareholder approval.

"Such an amendment would not be in the nature of a 'purchase or sale' of stock in one corporation for stock in 'another' corporation."

and would not therefore constitute a constructive purchase for purposes of Section 10(b). Id. at 539.

"Internal corporate changes alone cannot accomplish the same alteration in the nature of the corporate entity and the stockholders' interest." In re Penn Central Securities Litigation, 347 F. Supp. 1327, 1338 (E.D. Pa. 1972) (Lord, C.J.), aff'd, 494 F.2d 528, 532-39 (3d Cir. 1974).

Of the remaining revisions cited by the plaintiffs, only two (Nos. 6 and 7) could conceivably be said to disadvantage the limited partners, while nine undoubtedly benefited them and four were essentially neutral.* No. 6

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* Nos. 3, 4, 5, 8, 9, 12, 13, 14 and 16 were clearly beneficial to the limited partners. No. 3 was beneficial because it reduced the charge to them on new contributions to capital. No. 4 was beneficial because it limited the powers of the general partners and eliminated a covenant not to sue. No. 5 was beneficial because it increased the amount a limited partner could borrow against his capital account from 10 percent to 25 percent in any

(Footnote continued)

was not significant because it merely gave the managing partners as a group the right to draw against <u>their own</u> capital accounts in any year an amount limited to 10 percent of the partnership assets. No. 7 eliminated the 4 percent quarterly draw for limited partners, but was offset by the increase in the amounts which the limited partners could borrow against their capital accounts, in effect withdraw, from 10 to 25

(Footnote continued)

given year. No. 8 was beneficial because it reduced the required notice of withdrawals of capital by limited partners from 60 days to 30 days. No. 9 was beneficial because it eliminated the authority of the general partners to postpone valuation and pay out to withdrawing limited partners. No. 12 was beneficial because it gave the limited partners the right to reconsider their investment if any general partner withdrew from the partnership. No. 13 was beneficial because it required the partnership to distribute on withdrawal either cash or marketable securities, thus eliminating the possibility of a distribution of unregistered or otherwise restricted securities. No. 14 was beneficial because it gave the limited partners a voting participation in amendments to the partnership agreement. No. 16 was beneficial because it required the distribution of financial statements, which had not been explicitly required previously.

Nos. 1, 10, 11 and 15 were neutral in their effect (e.g., No. 1) or affected only the relations between the general partners (e.g., No. 10). No. 1 was neutral in effect because, as an analysis of Article 3 of the 1966 agreement and Article 1.04 of the 1968 agreement demonstrates, the scope of the authority of the general partners was extraordinarily broad under both agreements. No. 10 was neutral because it affected only the financial arrangements among the general partners and had no effect on the limited partners. No. 11 was neutral, and perhaps beneficial, because it fixed the duration of the partnership. No. 15 was neutral because it merely made explicit what is implicit in the nature of an investment partnership, i.e., that the limited partner's interest in the partnership had been acquired for investment purposes and not for resale to a third party.

percent. The re isions were certainly not uniformly adverse to the interests of the limited partners, as plaintiffs qui- e ly concede (Brief for Appellants, at 17*), but were in fact generally beneficial to them. See p. 19 n., supra.

Running through the Third Circuit's decision in Penn Central, and at the fore in considerations of common sense, is the premise that for a proposed revision to put an investor in the position of making an investment decision amounting to the "purchase" or "sale" of a security for Section 10(b) purposes, the proposal, if chosen, must have a potentially significant adverse impact on the investor. Other courts have recognized the same considerations.

District Judge Owen explicitly recognized this f n- damental precept of good sense in Browning Debenture Holders' Committee v. DASA Corp., supra, when he distinguished the citation by the plaintiffs in that case of SEC v. Associated Gas & Electric Co., 99 F.2d 795 (2d Cir. 1938) and Ingenito v. Bermec Corp., 376 F. Supp. 1154 (S.D.N.Y. 1974) (the same cases relied on by plaintiffs here), for the proposition

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* Plaintiffs' brief reads:

> "Some of the above changes no doubt attracted the investors to remain in the fold; others must have created opposite inclinations; with respect to still other provisions, advantages and disadvantages were difficult to predict."

that a reduction in the conversion price of debentures they held (an act clearly to their benefit) was an issuance and sale of a new security. Judge Owen stated:

> "These authorities [Associated Gas and Ingenito] are however no support for this position since they involve amendments to the disadvantage of the indenture holder, [not,] as here, beneficial to the holder." At 97,754 n.

Indeed, Judge Lasker in Ingenito, the case principally relied on by plaintiffs, himself recognized that Section 10(b) does not come into play, even for jurisdictional purposes, unless

> "there is alleged a substantial modification of an investment contract creating fresh rights and obligations of the parties and the investor gives some consideration, either a promise of future payments or the relinquishment of a significant right." 376 F.Supp. at 1182 (emphasis added).

Thus, even under the case relied upon by the plaintiffs, the only revisions to the partnership agreement in 1968 which would be relevant for purposes of determining whether a "significant investment decision," and hence a purchase, occurred would be those revisions which were to the substantial disadvantage of the limited partners. This is sound reasoning, for a choice between the status quo and something better involves no "significant investment decision" -- it is a gift.

Since the revisions did not substantially and adversely alter the rights of the limited partners, and did not amount to the equivalent of either an exchange of assets,

a merger or some other equally significant financial event, plaintiffs' claim that their acceptance of the 1968 revisions constituted a purchase of a new security within the meaning of Section 10(b) is clearly unsupportable.

POINT III

PLAINTIFFS HAVE NO CLAIM UNDER THE INVESTMENT ADVISERS ACT OF 1940 (A) BECAUSE NO PRIVATE CAUSE OF ACTION MAY BE IMPLIED UNDER THAT ACT AND (B) BECAUSE DAMAGES UNDER THAT ACT ALSO MUST BE LIMITED TO OUT-OF-POCKET LOSS

Although the plaintiffs' brief (at 44-45) makes only passing reference to their purported claim for damages under Section 206 of the Investment Advisers Act, 15 U.S.C. § 80b-1 et seq., some discussion of that Act is appropriate, because the federal courts have no jurisdiction to entertain actions at law under that Act, even if a private right of damages could be implied, which it cannot, and because any such implied right of action would necessarily have to be limited to out-of-pocket damages.

A. No Private Right of Action May Be Implied Under The Investment Advisers Act of 1940

Although the Supreme Court has frequently recognized the important role which implied remedies may play in securing compliance with the securities laws (See, e.g., SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195

(1963)), no Court of Appeals* and only three District Courts have been called upon in the 35 years since passage of the Advisers Act to confront directly the issue of whether a private right of action may be implied under that Act. Bolger v. Laventhol, Krekstein, Horwath & Horwath, CCH Fed. Sec. L. Rep. ¶ 94,739 (S.D.N.Y. 1974) (Metzner, J.); Gammage v. Roberts, Scott & Co., [Current] CCH Fed. Sec. L. Rep. ¶ 94,761 (S.D. Cal. 1974) (Turrentine, J.); Greenspan v. Eugene Campos Del Toro, 73-638-Civ. (S.D. Fla., May 17, 1974) (Eaton, J; unreported opinion). In Bolger, Judge Metzner held that such a right of action could be implied. In Gammage and Greenspan, Judges Turrentine and Eaton held to the contrary. We respectfully submit that Judge Turrentine and Judge Eaton were correct and that Judge Metzner was in error.

Unlike Section 22 of the 1933 Act, 15 U.S.C. § 77v, Section 27 of the 1934 Act, 15 U.S.C. § 78aa, and Section 44 of the Investment Company Act of 1940, 15 U.S.C. § 80a-43, all of which expressly create district court jurisdiction of "all

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* In Brouk v. Managed Funds, Inc., 286 F.2d 901 (8th Cir. 1961), the Eighth Circuit held that no private right of action could be implied under the Investment Company Act and indicated a similar conclusion with respect to the Advisers Act without specific analysis of the important differences between even those two Acts.

suits in equity and actions at law brought to enforce any liability or duty created" by the Acts (emphasis added), Section 214 of the Advisers Act, 15 U.S.C. § 80b-14, contains no conferral of jurisdiction upon the federal district courts to entertain actions at law under that Act and makes no reference to the enforcement of "any liability" created by the Act.*

In Bolger, Judge Metzner explained away this obvious departure in statutory draftmanship by seizing on the word "violations" in Section 214 as being the equivalent of "all suits in equity and actions at law" (without discussing the equally significant omission of the phrase "any liability" created by the Acts), and by rationailzing that the omission could also be explained by the failure of Congress to enact "any provision expressly authorizing a civil action by a private person injured by a violation of one of the provisions of the Act." CCH Sec. L. Rep. ¶ 94,618 at 96,190 (emphasis in original). This reasoning is simply not persuasive.

The Investment Advisers Act was one of the last of the major securities acts passed between 1933 and 1940. When Congress passed the Act it clearly knew how to create a pri-

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* The four jurisdictional sections, in relevant part, appear in a Statutory Appendix to this Brief.

vate cause of action, and how to confer on the federal courts jurisdiction to entertain such actions, when it wished to do so. That the Advisers Act is the only one of these statutes in which Congress did not do expressly confer jurisdiction on the federal courts to entertain "actions at law" or to enforce "any liability" created by the Act, as it had done in the other securities acts, is compelling evidence that it did not <u>intend</u> to do so, which cannot be explained away by upside-down logic that the omission stemmed from Congress's decision not to provide <u>any</u> private right of action under the Advisers Act. To imply a private right of action from Congress's failure to provide for a private right of action turns statutory construction on its head and implies a degree of congressional obtuseness that is wholly incompatible with the judicial process and the comity between the legislative and judicial branches of government.

Moreover, however justified it may be for the federal courts to imply private rights of action from regulatory statutes where Congress has granted them jurisdiction to entertain "actions at law" to enforce "liabilities" created by the statute, it is absolutely improper for the courts to imply a grant of jurisdiction which Congress never conferred. Only Congress has the power to confer jurisdiction on the federal courts, <u>Sheldon v. Sill</u>, 8 How. 440,

12 L. Ed. 1147 (U.S. 1850), and any effort by the courts to create their own jurisdiction would constitute an unconstitutional usurpation of congressional powers.

Finally, even if there were a basis for implication of a private remedy under the Advisers Act, there is obviously no compelling necessity for the recognition of private rights of action under it, since the issue never arose for 34 years following the passage of the Act.

Accordingly, plaintiffs' claims under the Investment Advisers Act should be dismissed for lack of subject matter jurisdiction.

B. Damages Under The Investment Advisers Act Must Be Limited To Actual Damages

As the court below recognized, principles of statutory application dictate that the measure of damages be consistently applied. In Point I of this brief, supra, we demonstrated that the federal rule of damages is limited to out-of-pocket loss or the defendants' profit, whichever is greater. Even if a private cause of action could be implied under the Advisers Act, that limitation on recovery should, as the court below held, be applied.

While, as Judge Carter recognized, the Advisers

Act contains no express limitation to actual damages such as that found in Section 28(a) of the 1934 Act, the same limitation should be applied in any private action under the Advisers Act because, as demonstrated in the preceding section, Congress never intended to create _any_ private right of action express or implied under the Advisers Act. To imply a right of action _broader_ than that prescribed by Congress where it explicitly legislated would, as Justice Rehnquist indicated in _Blue Chip_ in refusing to interpret Section 10(b) more broadly than Sections 11 and 12 of the 1933 Act, be inconsistent with congressional intent. 43 U.S.L.W. at 4716.

CONCLUSION

Plaintiffs present on this appeal the typical claims of disappointed investors who regret not having cashed in earlier and who are now searching for investors' insurance. They speculate that they would have withdrawn in 1968 had they been "told the truth" about the unregistered investments which account for so much of the extra gain they now seek to recover. They urge upon this Court the novel proposition that their consent to minor changes in the partnership agreement should now become a $1.7 million investment procured by defendants' "fraud."

Plaintiffs' novel and speculative legal theories, however, are unsupported by precedent and contradicted by persuasive authority. Accordingly, the appeal from the Order and Judgment of the District Court should be dismissed.

September 22, 1975

Respectfully submitted,

SULLIVAN & CROMWELL
Attorneys for Defendants
Malcolm K Fleschner,
William J. Becker and
Fleschner Becker Associates
48 Wall Street
New York, New York 10005

Of Counsel

Richard E. Carlton
Robert D. Owen

STATUTORY APPENDIX

JURISDICTIONAL PROVISIONS OF THE SECURITIES LAWS

Securities Act of 1933

Section 22, 15 U.S.C. § 77v, reads, in relevant part:

"Jurisdiction of Offenses and Suits

Section 22. (a) The district courts of the United States, the United States courts of any Territory, and the United States District Court for the District of Columbia shall have jurisdiction of offenses and violations under this title and under the rules and regulations promulgated by the Commission in respect thereto, and concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this title. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347). . . ."

Securities Exchange Act of 1934

Section 27, 15 U.S.C. § 78aa, reads, in relevant part:

"Jurisdiction of Offenses and Suits

Section 27. The district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. . . . Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347). . . ."

Investment Company Act of 1940

Section 44, 15 U.S.C. § 80a-43, reads, in relevant part:

"Jurisdiction of Offenses and Suits

Section 44. The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this subchapter or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation

of, this subchapter or the rules, regulations, or orders thereunder. . . . Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, this subchapter or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, 1292, and 1294 of Title 28. . . ."

Investment Advisers Act of 1940

Section 214, 15 U.S.C. § 80b-14, reads, in relevant part:

"Jurisdiction of Offenses and Suits

Section 214. The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this subchapter or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity to enjoin any violation of this subchapter or the rules, regulations, or orders thereunder. . . . Any suit or action to enjoin any violation of this subchapter or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28, and section 7, as amended, of the Act entitled "An Act to establish a court of appeals for the District of Columbia", approved February 9, 1893. . . ."

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

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ROBERT ABRAHAMSON, et al., :

Plaintiffs-Appellants, :

-against- :

MALCOLM K. FLESCHNER, et al., :

Defendants-Appellees. :

\- x

STATE OF NEW YORK)
: SS.:
COUNTY OF NEW YORK)

GEORGE A. SCHOLZE, being duly sworn, deposes and says that he is an attorney associated with Sullivan & Cromwell, attorneys for Defendants Malcolm K. Fleschner, William J. Becker and Fleschner Becker Associates; that on the 23rd day of September, 1975 he caused the within Brief to be served upon the following attorneys at the following addresses, by having two true copies of the same to each attorney, securely enclosed in a postpaid wrapper to be deposited in the Post Office Box regularly maintained by the United States Government at 48 Wall Street, Borough of Manhattan, City and State of New York, directed to said attorneys at said addresses as follows:

D'Amato, Costello & Shea
Attorneys for Harry Goodkin & Company
116 John Street
New York, N.Y. 10038

Hills, Betts & Nash
Attorneys for Harold B. Ehrlich
One World Trade Center
Suite 5215
New York, N.Y. 10048

George A Scholze

Sworn to before me this
24th day of September, 1975

Alan [illegible]

Notary Public

ALAN [illegible]
Notary Public, State of New York
Residing in Kings County
Kings Co. Clk's No. 24-7031350
Certificate filed in
New York Co. Clk's
Commission Expires March 30, 1976